REINVENTING BRETTON WOODS COMMITTEE

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International Financial Integration and Fragmentation

Foreword by the Executive Director Marc Uzan

The global economy is facing a major set of challenges, with great experimentation and transformation under way in terms of the macroeconomic framework in advanced countries. All of which will have major consequences to the rebuilding of the global financial system post crises. Today we are into the second decade of the 21th century, and the need for international cooperation is confronted by the choice of fragmentation and segmentation which is a move away from multilateralism that marked the Bretton Woods era.

On this outline, last summer we organized with the Central Bank of Turkey the conference titled *"Fragmentation in the International Financial System: Can the Global Economy become on again?"* in Cappadocia, Turkey on 14-15 July where we first addressed the critical obstacles to recovery of the international economy. In November 2012 we readdressed the topic of segmentation and strained multilateralism at a conference in Beijing that we co organized with the International Trade and Cooperation Academy Forum. The discussions centered on debt overhangs, significant macroeconomic distortions, adverse incentives for adjustment and deficient governance structures that constrain a resolution of the crisis in the Europe and the United States and risk causing an increasing fragmentation of the international economy.

Today the big question we face is; how will the global economy cope with its own segmentation. If multilateralism can't bind nations together, do we resort to regional groupings? More broadly, what is at stake can be readily grasped with the help of the concept of a new "geography" in international finance?

This implies that international financial relations will not be viewed through the lens of a US-Europe centric world but include a wider diversity of players, including Brazil, India, and China among others. Just as the US and Europe found it difficult to accept the rise of Japan as a major economy power, so there is likely to be anxiety about the emergence of China, India, Brazil or South Korea. Will they be up to the task of being at the same time assertive and constructive? Will they elaborate their vision of the future of making the global financial system less vulnerable and more resilient?

In this edition we revisit these issues along with new perspectives we gathered at our recently organized conference with Bank of Spain in Madrid titled "*International Financial Integration : Drivers and Policy responses.*

In our next edition we review the role of local bond markets in long-term finance, and whether international local bond markets in emerging market economies have a role at the international level, based on the discussions at our latest conference "Global Finance in Transition" held on May 7^{th}-8^{th} in Istanbul Turkey.

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BANCO DE ESPAÑA
Eurosistema

INTERNATIONAL FINANCIAL INTEGRATION AND FRAGMENTATION: DRIVERS AND POLICY RESPONSES

Banco de España, Madrid, 12th March 2013

Section 1: Integration and fragmentation: Contours of the new financial landscape

Jan Brockmeijer (IMF)
Throsten Beck (University of Tilburg)
Thomas Huertas (Ernst & Young)
John Clark (NYFed)

Section 2: Implications of the European crisis for the single financial market

Ignazio Angeloni (ECB)
David Vegara (ESM)
Jean Pisani Ferry (Bruegel)
Alberto Giovannini (Unifortune)

Keynote speech: Benoît Coeuré (ECB)

Section 3: International financial integration and fragmentation: The view from Central Banks

Julio Velarde (BC del Perú)
Luiz Pereira (BC do Brasil)
Jean Pierre Landau (Sciences Po.)
William Perraudin (Risk Control)

Concluding remarks from Marc Uzan (RBWC) and Pilar L'Hotellerie-Fallois (BdE)

Please find the papers of the conference on the website of Bank of Spain http://www.bde.es/bde/en/

OVERVIEW OF THE CONFERENCE

In the decade leading to the 2008 financial crisis, global markets underwent unprecedented integration, facilitated by financial innovation. New regulations created a framework that gave banks a standardized way to measure complex risks, delegating some of their analysis to credit rating agencies and create leverage. The consequence was unrealistic pricing of assets, with some even being treated as risk free due to their "stable" spreads, ranging from mortgage backed securities to sovereign bonds.

The on-going debt crisis has put an end to the financial integration and bubble driven growth of the previous two decades. The banking and financial sectors have subsequently gone through crisis and restructuring, while regulatory framework has tried to catch up with the innovation that caused the crisis. One of the results of the financial crisis has been a fragmentation of international financial system.

This financial fragmentation has changed the landscape of Europe's and emerging market's financial sector. Eurozone banks have reduced exposure to risky assets in peripheral European economies. Due to the changing nature of the regularly environment, banks have also been forced to change their operating models, the way their credit is allocated and risks managed in different geographies. This retracement and the vacuum created in certain markets has led corporations to seek new sources of funding.

Why is Europe fragmented?

The on-going Eurozone crisis has accentuated the mismatch between the supply and demand of credit. Core banks have been reducing exposure to periphery countries, leading to a credit shortage in countries where public finances are already strained. Banks in core countries have also shrunk their balance sheets in their home markets in response to new capital adequacy requirements. While liquidity has been abundant, this has not been transformed into physical investment.

Banks are more transparent and less complex than before the crisis, but the banking sector is also smaller and less interconnected than before. Banks are keeping locally funded deposits within their borders, reducing their exposure to riskier periphery assets and changing the way banks extend credit.

Regulators, meanwhile, are pressuring their domestic banks to maintain safer balance sheets. Banks are shedding risky assets and not buying debt from countries with strained public finances and huge debts, such as Italy and Spain. This is a rational response from regulators to banks, but not optimal for the Eurozone.

In response to these credit limitations, corporations are hoarding cash and issuing record levels of debt to finance their investments. Banks are trading less and focusing more on being the intermediary between deposits and high quality investments within their own borders. Between 2007 and 2012, global cross border lending fell from $5.6 trillion to $1.7 trillion, according to McKinsey. These reduced flows are changing the banking system and encouraging the emergence of shadow banking, where non-bank financial institutions are using their liquidity to fund investment opportunities.

Could a banking union help?

From a structural perspective, Europe's financial markets are seriously fragmented. Despite the European Central Bank President Draghi's "whatever it takes" commitment to support markets in July 2012, stresses were relieved in the Eurozone, but there are still serious structural issues that have to be solved.

Many banks remain unable to access financial markets to fund their daily activities and must pay high premiums for overnight rates. Operating costs for the weaker banks are much higher than they should be, making it difficult for them to lend. This is particularly impacting the smaller periphery banks.

Foreign creditors are withdrawing their capital from periphery nations, leaving the Eurosystem (EFSF, ESM, bond purchase programs, LTRO…) as the only source of capital for these troubled nations. Bank's willingness to lend in different countries varies significantly, with different funding costs impair monetary policy transmissions. As some of the speakers of the conference pointed out, perhaps one of the big problems is that there is no "euro area risk-free asset" to use as a benchmark against all investments, meaning there is no efficient risk-taking by financial institutions. Consequently, the European Union is failing to reap the benefit of a monetary union.

Most of the speakers argued for a banking union, a supra-national authority designed to supervise Eurozone banks. By tackling bank fragility in the periphery countries of the Eurozone, and by ensuring risk sharing with their members, a banking union has the potential to get European credit taps flowing again. There seemed to be a general consensus at the conference that this is a long-term solution, and that proper structure and implementation be finalized before putting the system in place. This will certainly not cure all of Europe's problems, but it can fill many gaps. As one speaker pointed out, the Eurozone crisis is a governance crisis; different narratives among creditors and debtors reduce political legitimacy of governments. Therefore, it is argued that electoral support is vital to such a plan being accepted.

How are emerging markets affected by international fragmentation?

New conditions in emerging market economies are creating new challenges. Record global liquidity in advanced economies and higher yields in emerging markets are creating greater capital inflows. Latin America, for example, is experiencing improved fundamentals, getting a larger share of global allocation from investors. Low inflation, sustained growth and solid financial positions support the improved market sentiment and better credit ratings. Foreign direct investment has become an important source of funding, along with bond markets, while bank credit remains a more domestic phenomenon.

The main challenge facing emerging markets is thus to limit short-term, volatile capital flows while not incentivizing shadow banking. Foreign investors and domestic recipients are also constantly innovating to elude regulation; central banks and regulatory agencies must therefore have to strengthen their prudential regulations while monitoring these macro risks.

With respect to bank assets, emerging market banks are expected to outgrow those in advanced economies. By 2013, emerging market banks should double their assets to almost 45% of total global bank assets, overtaking advanced economies' financial sector. As a result, global growth will be led by emerging markets, at the expense of the relative decline of advanced economy's banks. Regulators must therefore broaden and diversify their scope while maintain global coordination to ease credit conditions and avert another financial crisis.

How will these players adapt?

Central banks and regulators must truly understand how the financial picture has changed. How will the new players on the financial scene adapt? How can central banks and regulators properly identify gaps in the system and prevent a crisis before it happens? Can these authorities protect their domestic financial stability while not encouraging protectionism?

The banking sector has significantly changed since 2008. Banks are less linked and simpler than before, and are no longer the main source of funding to corporations and households. Shadow banking is emerging as a key player in the financial world, but they are not regulated the same way and can therefore find loopholes that can threaten the system.

The speakers at this conference were clear and to the point: the financial picture in Europe has changed, emerging markets are becoming an increasingly dominant player and regulative authorities must remain vigilant and pro-active to avoid another crisis.

The situation in Cyprus has come to the fore over the last couple of weeks. During the conference in early March, some of the speakers argued for the pressing need of unified deposit insurance, where a deposit in a core country was protected by the same-pooled money as one in another country. Given the unfolding circumstances seen recently in one of the tiniest members of the European Union, it is now probable that a blanket deposit scheme is off the table for the foreseeable future.

Summary of Luis M. Linde's speech :

The Banco de España's Governor Luis Linde kick-started the conference with a speech introducing the problems and the challenges facing central banks and regulators.

Mr. Linde started by realizing that although the financial crisis is five years behind us, it remains hard to appreciate the changes the global financial system is going. The reduction in financial linkages between national financial systems are starting to present itself.

The role of Central Banks and regulators are crucial, as they must be careful in promoting and maintaining domestic financial stability without becoming protectionists, which would damage growth and prosperity.

Crisis and policy responses have created new funding patterns, new players and important changes for global capital flows. The Euro area's crisis has resulted in fragmentation of Europe's financial system; while there are signs of reversal of this process, such failure would be harmful for the European Union.
Mr. Linde concluded by highlighting the role of central bankers in this new financial landscape. Central banks have become big players in the financial arena, from a regulatory and monetary policy standpoint. Therefore, their actions and reactions must change and adapt to such a new environment.

Summary of Benoît Coeuré's speech :

As the keynote speaker of our conference in Madrid, European Central Bank Executive Member Benoît Coeuré discussed the current state of fragmentation in the euro area and ways to fix the problems. His speech contained precise details and analysis, more than this newsletter could contain. The link to full text can be found at the bottom of this page. The following is a summary of his speech:

Financial integration is a situation where economic agents seeking to access capital are not discriminated against, particularly based on their geographic location. Market participants have been pricing risk based on the geographic origins of the counterparties and the collateral, severely impairing the efficient allocation of capital and unevenly transmitting monetary policy across different regions of the Eurozone.

The financial crisis made it apparent that cross-border capital flows are subject to sudden stops; banks became reluctant to lend to one another as soon as counterparty risks emerged. Sudden stops would probably have not occurred had proper financial integration in different market segments been less sensitive to information and counterparty credit risk.

Mr. Coeuré proposed that financial integration could be achieved with the creation of a banking union, with its objective to build an integrated framework that safeguards financial stability and minimizes the cost of bank failures. Such a union would require four building blocks: (a) a single rulebook, (b) a Single Supervisory Mechanism, (c) a Single Resolution Mechanism and a Single Resolution Authority, and (d) the establishment of common deposit protection. Mr. Coeuré also argued that a more integrated European corporate bond market and equity market could help firms raise funds when banks are deleveraging.

Mr. Coeuré concluded his speech by reminding his audience that re-integration of financial markets has the potential to be self-reinforcing, which can unleash virtuous dynamics in the Eurozone and be conducive to a more efficient allocation of resources.

The full text of the two speeches can be found at:

http://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/Agenda/Eventos/13/03mar/lined120313e.pdf

http://www.ecb.int/press/key/date/2013/html/sp130312.en.html

FRAGMENTATION: CAN THE GLOBAL ECONOMY BECOME ONE AGAIN?

By Ousmene Mandeng

Held in Cappadocia, Turkey, the conference jointly organized by Central Bank of Turkey and RBWC titled *"Fragmentation in the International Financial System: Can the Global Economy become on again?"* focused on likely critical obstacles to a recovery of the international economy and brought together senior officials from major central banks and leading academics and market representatives. The meeting stressed and participants seemed broadly in agreement with persistent debt overhangs, significant macroeconomic distortions, adverse incentives for adjustment and deficient governance structures that constrain a resolution of the crisis in the Europe and the United States and risk causing an increasing fragmentation of the international economy. My main takeaways from the meeting is that debt restructuring for highly indebted advanced economies ought to form an integral part of the current crisis resolution strategy, that there may be inherent flaws in the very expansionary monetary policies undermining their effectiveness, that global imbalances may prevail and that perceived deficient governance in particular at the IMF need to be addressed much more forcefully to restore confidence in effective multilateralism.

Expansionary monetary policy:

Participants appeared broadly in agreement that the significant expansion of key central banks' balance sheets expansions has had a favourable accommodative effective but disagreement prevailed of whether the ECB's stance remains too restrictive and concern voiced about untended policy consequences. One participant indicated that central banks' balances increased through net domestic asset creation in advanced economies and net foreign asset creation in emerging markets leading to unprecedented monetary expansions. Another participant stressed that he was surprised that the U.S. economy was not growing stronger despite the U.S. Federal Reserve's very expansionary monetary policy stance. The limited success of monetary policy in stimulating the economy, another participant remarked, may be attributed to the fact that the nature of monetary expansion is not favourable to credit expansion as monetary base has been created mostly through collateralised flows on the basis of securities of deleveraging governments. One participant underscored that the ECB's monetary policy remains too restrictive preventing the euro from depreciating sufficiently to help the recovery.

Inflation:

Views on the effect of expansionary policy in advanced economies on inflation were mixed. One participant stressed that central banks know how to exit the expansionary monetary stance in the event of an increase in inflation. Another participant highlighted, with reference to the experience of Germany in the 1920s that expansionary monetary policy may take a long time before affecting inflation but that inflation may then increase exponentially. One participant emphasised that the introduction of an inflation target by the Fed was to anchor inflation expectations amid the use of non-conventional monetary policy measures to allow a more aggressive policy stance. The differences in consumer baskets between emerging markets and advanced economies given a higher share of food prices and a reduced effect from price declines of technology-intensive products due to late adoption in consumer baskets, can explain significant differences in inflation according to one participant. The participant further highlighted that emerging markets should therefore aim for higher inflation targets and that emerging markets currencies would need to appreciate to overcome the disinflation bias in advanced economies' consumer prices.

Macroeconomic distortions and spillovers:

Participants shared the view about the prevalence of significant distortions in the international economy. Several participants highlighted that the built-up of international reserves represented itself a major distortion; this is also particularly relevant amid the implied considerable hording of safe and liquid assets .One participant stressed that the zero-interest policy and low or negative real interest rates may have adverse effects on investments as it reduces incentives for adopting high productivity activities amid the positive correlation between the natural rate of interest and productivity levels. The participant therefore argued that the zero-interest policy needs to be abandoned. Another participant indicated, amid criticism about adverse spillovers from monetary policy, that it would be very difficult and not democratically viable for the Fed to take into account external considerations indicating that the Fed could not be asked to sacrifice output to help manage another country's crisis. One participant remarked that the Fed's view represents a major age-old dilemma for the international monetary system amid the conflict of using national currencies to manage international liquidity.

Global imbalances:

Participants stressed concern about the possible persistence of global imbalances. Several participants indicated that they were in disagreement with IMF projections of a gradual reduction in external current account imbalances but saw rather renewed increases. One participant argued that the core problem of global imbalances was the asymmetry between bond and equity investments between the U.S. and Asia. The participant stressed that the development of bond markets in Asia is critical to mitigate the former. Another participant emphasised that the recent decline in current account imbalances was only due to a decline of trade in percent of global output and the increasing share of government expenditure that includes less tradable goods. The participant noted that unlike the Eurozone the U.S. did not face a sudden stop but a significant decline in private consumption while the decline of China's current account surplus was also attributed to a decline in trade and an adverse terms of trade shock. The participant therefore stated that external imbalance will continue to increase also stressing that the fundamental incentives for the U.S. to run large current account deficits has not changed due to continuous availability of cheap borrowing. Another participant underlined the importance of central banks in financing the global imbalances and that changes in international reserve accumulation and in particular allocation may be critical to mitigate a renewed built-up of global imbalances.

Mexico and Eurozone crises:

Several participants highlighted parallels between past debt crises in emerging markets and today's Eurozone crisis. One participant remarked that as in Mexico in 1994 the sharp increase in domestic credit and decline in international reserves is similar in effect as the sharp credit expansion in peripheral Eurozone countries and subsequent support operations like the ECB's LTROs and ELA and EFSF flows as reflected in the TARGET2 balances. The participant quoted the late [MIT professor of economics] Rudiger Dornbusch saying that the difference between emerging markets and advanced economies is only that advanced economies can sustain bad policies for longer. One participant stressed that on crisis resolution the Mexico Brady plan offered the essential element of debt forgiveness that led to a rebound in growth while Eurozone policy makers continue to resist a comprehensive debt restructuring. However, another participant argued that in Mexico the Brady plan came only at the end of a process of continuous adjustment and that the subsequent rebound in activity may also be attributed to other factors. One participant underlined that the Eurozone sustains the worst possible policy mix amid being forced to conduct pro-cyclical fiscal policy while monetary policy remains too restrictive.

Credit growth and debt overhang:

Many participants stressed the importance of rapid credit expansion in the run-up to the crises in the U.S. and the Eurozone. One participant highlighted that credit growth contains valuable information about the economy that conventional inflation targeting would miss. Another participant remarked that private debt will be a key factor in determining the recovery reminding the audience that in Japan in 1990 nobody would have thought that it would take two decades to recover from the credit bust. Another participant noted that in the Eurozone debt will need to be reprofiled as a necessary condition for a sustainable recovery. The participant remarked privately that debt restructuring of households in the U.S. and some Eurozone countries may be essential to allow for an earlier recovery. Another participant highlighted that it was a surprise not to see a reactivation of the efforts at the IMF during the early 2000s to establish a sovereign debt restructuring mechanism (SDRM) to facilitate sovereign debt workouts.

Protectionist measures:

Several participants indicated that the global crisis has given rise to new protectionist measures and produced adverse capital flow effects. Several participants noted that some countries had taken measures to curb current and capital transactions. One participant argued that the inclusion of South Africa in the Citi World Government Bond Index is likely to change the dynamic of capital flows. Another participant remarked that the Philippines encouraged outflows as a measure to deal with the spillovers of the global crisis. One participant stressed that the G20 efforts to avoid a renewed rise in protectionist measures has been important.

Crisis resolution resources:

Participant held different views about the adequacy of resources for crisis resolution. Several participants stressed the need for strengthening the global financial safety net. One participant argued that while international reserves have naturally reduced the need for external assistance, the size of reserves limits actual liquidity and emphasised that the inter-central bank swap arrangements may be a possible solution. One participant indicated the significant increase in IMF resources, greater flexibility for access of resource and less conditionality. Another participant noted that there is a risk that by reducing conditionality and increasing flexibility for access the IMF may undermine its essential comparative advantage of conditionality-based lending. Another participant highlighted though that the establishment of the EFSF/ESM (Europe), FLAR (Latin America) and AMRO/CMIM (East Asia) pointed towards a rising fragmentation of financial crisis resolution resources and that the IMF may need to find new ways to coordinate those resources to remain relevant. One participant underscored that the CMIM now has USD240 billion in available resources and that the portion delinked from IMF involvement was increased to 30 percent.

One participant advanced that it may be better for the IMF no longer to lend but only provide advice to which another participant retorted that IMF effectiveness seems to rest largely in its ability to lend.

Another participant voiced concern that the current system of multilateralism rests on a fundamental asymmetry by which only advanced economies have the ability to create net international liquidity while emerging markets through the use of their international reserves merely recycle existing liquidity and that greater recognition of emerging markets as an equal partner would to a large extent depend on their ability to supply convertible and international useable currencies for crisis resolution.

IMF and multilateralism:

Views on effectiveness of IMF involvement in Europe and status and relevance of and condition for effective multilateralism more broadly were mixed. Several participants stressed that the IMF remains the best placed institution for global economic policy dialogue though some participants highlighted that the G20 has assumed a key lead role. Another participant indicated that the latter part of the crisis has seen little to no guidance and leadership from the IMF, G20 and WTO while another participant stated that the G20 Los Cabos proceedings were particularly ineffective. The Troika approach in Eurozone countries, involving the ECB and EU Commission, was seen by one participant as highly undesirable as it risks impairing the IMF's technocratic approach for the assessment of IMF arrangements likely diminishing its effectiveness and institutionalising political meddling. Another participant noted that it would be naïve to assume that as the Eurozone itself co-finances directly the IMF arrangements in the Eurozone it would be willing to forgo a direct involvement. This, the former participant underscored, would represent though the essence of subordinating national or regional interests to a multilateral approach and saw this also as a sign of an increasing erosion of multilateralism. Another participant outlined that the fact that Asia had contributed in providing additional IMF resources was an important symbolic achievement that confidence in the multilateral approach prevails.

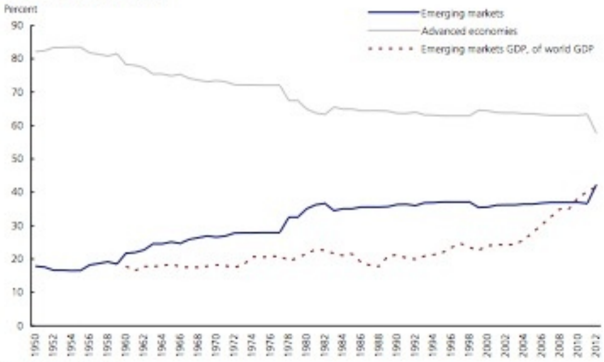
MF governance reform:

Participants had mixed views whether the pending 2010 quota and governance reform of the IMF was enough to address perceived wide-ranging governance deficiencies. One participant highlighted that with the reform emerging markets and developing countries would see a significant increase in their quota shares to about 42 percent broadly in line with their share in world output and that this would constitute an adequate representation (Chart).

However, the participant also stressed that the Troika approach and perceived exceptionalism of some IMF member countries has deepened suspicion about the effectiveness and relevance of governance reform. The participant also noted that there are many factors apart from quotas that determine influence at the IMF including the quality of the Executive Directors [at the IMF Board] and representation among the staff

Another participant argued that as the U.S. sees its global influence decline, being the main shareholder of the IMF, the IMF is also set to decline to which one participant remarked that it was indeed surprising that the U.S. did not show more engagement to strengthen the one institution it still dominates against the formation of new institutions were it has less involvement. One participant remarked that Turkey has formed a new Eastern European constituency at the IMF together with Austria, Belarus, Czech Republic, Hungary, Kosovo, Slovakia and Slovenia as an indication of deeper IMF engagement.

Chart. IMF quota shares



Source: IMF, World Bank.

All the papers presented at this conference can be found on the website of the Central Bank of Turkey: http://www.tcmb.gov.tr/yeni/eng/

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